

BANKRUPTCY BASICS

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CHAPTER 9 - MUNICIPALITY BANKRUPTCY

HISTORY OF CHAPTER 9

The first municipal bankruptcy legislation was enacted in 1934 during the Great Depression. Pub. L. No. 251, 48 Stat. 798 (1934). Although Congress took care to draft the legislation so as not to interfere with the sovereign powers of the states as guaranteed by the Tenth Amendment to the Constitution, the Supreme Court held the 1934 Act unconstitutional as an improper interference with the sovereignty of the states. Ashton v. Cameron County Water Improvement District No. 1, 298 U.S. 513 (1936). Congress enacted a revised Municipal Bankruptcy Act in 1937, Pub. L. No. 302, 50 Stat. 653 (1937), which was upheld by the Supreme Court. United States v. Bekins, 304 U.S. 27 (1938). The law has been amended several times since 1937, most recently in 1994 (amending section 109(c)) as part of the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (codified as amended at 11 U.S.C. 901 to 946) (1994). In the more than 60 years since Congress established a federal mechanism for the resolution of municipal debts, there have been fewer than 500 municipal bankruptcy petitions filed. Although chapter 9 cases are rare, a filing by a large municipality can - like the 1994 filing by Orange County, California - involve many millions of dollars in municipal debt.

PURPOSE OF MUNICIPAL BANKRUPTCY

The purpose of chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts. Reorganization of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan.

Although similar to other chapters in some respects, chapter 9 is significantly different in that there is no provision in the law for liquidation of the assets of the municipality and distribution of the proceeds to creditors. Such a liquidation or dissolution would undoubtedly violate the Tenth Amendment to the Constitution and the reservation to the states of sovereignty over their internal affairs. Indeed, due to the severe limitations placed upon the power of the bankruptcy court in chapter 9 cases (required by the Tenth Amendment and the Supreme Court's decisions in cases upholding municipal bankruptcy legislation), the bankruptcy court generally is not as active in managing a municipal bankruptcy case as it is in corporate reorganizations under chapter 11. The functions of the bankruptcy court in chapter 9 cases are generally limited to approval of the petition (if the debtor is eligible), confirmation of a plan of debt adjustment, and ensuring implementation of the plan. As a practical matter, however, the municipality may consent to have the court exercise jurisdiction in many of the traditional areas of court oversight in bankruptcy, in order to obtain the protection of court orders and eliminate the need for multiple forums to decide issues.

MEDIA INTEREST

The news media frequently is more interested in municipal bankruptcy cases than in cases filed by individuals or small businesses. As a consequence, some courts have a written policy for court personnel regarding the information that may or may not be released to the media in a case filed under chapter 9. Some courts also designate a public information officer to act as the contact person for all media inquiries concerning the municipal bankruptcy case.

ELIGIBILITY

Only a "municipality" can file for relief under chapter 9. The term "municipality" is defined in the Code to mean "political subdivision or public agency or instrumentality of a State." 11 U.S.C. 101(40). The definition is broad enough to include cities, counties, townships, school districts, and public improvement districts. It also includes revenue-producing bodies that provide services which are paid for by users rather than by general taxes, such as bridge authorities, highway authorities, and gas authorities.

There are three additional eligibility requirements for chapter 9: (1) the entity must be specifically authorized to be a debtor under such chapter by State law or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter, (2) the municipality must be insolvent as defined in 11 U.S.C. 101(32)(C), and (3) the municipality must desire to effect a plan to adjust such debts and either

- has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan in a case under chapter 9;
- has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan;
- is unable to negotiate with creditors because such negotiation is impracticable; or
- reasonably believes that a creditor may attempt to obtain a preference.

11 U.S.C. 109(c).

COMMENCEMENT OF THE CASE

Municipalities must voluntarily seek protection under the Bankruptcy Code. 11 U.S.C. 303, 901(a). They may file a petition only under chapter 9. A case under chapter 9 concerning an unincorporated tax or special assessment district that does not have such district's own officials is commenced by the filing of a voluntary "petition under this chapter by such district's governing

authority or the board or body having authority to levy taxes or assessments to meet the obligations of such district." 11 U.S.C. 921(a).

A municipal debtor is required to file a list of creditors. 11 U.S.C. 924. Normally, the list of creditors is filed with the petition. However, in some situations, the debtor may not have adequate time to prepare a list of creditors in the form and with the detail required by the Bankruptcy Rules. Thus, the Bankruptcy Rules permit the court to fix a time within which the list must be filed. Fed. R. Bankr. P. 1007.

ASSIGNMENT OF A CASE TO A BANKRUPTCY JUDGE

One significant difference between chapter 9 cases and cases filed under other chapters is that the clerk of court does not automatically assign the case to a particular judge. "The chief judge of the court of appeals for the circuit embracing the district in which the case is commenced [designates] the bankruptcy judge to conduct the case." 11 U.S.C. 921(b). This provision was designed to remove politics from the issue of which judge will preside over the chapter 9 case of a major municipality and to ensure that a municipal case will be handled by a judge who has the time and capability of doing so. S. Rep. No. 458, 94th Cong., 1st Sess. 15 (1975) (legislative history of Bankruptcy Act - Debts of Municipalities, Pub. L. No. 94-260, 90 Stat. 315 (1976)). See also S. Rep. No. 989, 95th Cong., 2d Sess. 110 (1978).

NOTICE OF CASE/OBJECTIONS/ORDER FOR RELIEF

The Bankruptcy Code requires that notice be given of the commencement of the case and the order for relief. 11 U.S.C. 923. The Bankruptcy Rules provide that the clerk, or such other person as the court may direct, is to give notice. Fed. R. Bankr. P. 2002(f). Such notice must also be published "at least once a week for three successive weeks in at least one newspaper of general circulation published within the district in which the case is commenced, and in such other newspaper having a general circulation among bond dealers and bondholders as the court designates." 11 U.S.C. 923. The court typically enters an order designating who is to give and receive notice by mail and identifying the newspapers in which the additional notice is to be published. Fed. R. Bankr. P. 9008.

The Bankruptcy Code permits objections to the petition to be filed. 11 U.S.C. 921(c). Typically, objections concern issues like whether negotiations have been conducted in good faith, whether the state has authorized the municipality to file, and whether the petition was filed in good faith. If an objection to the petition is filed, the court must hold a hearing on the objection. Id. The court may dismiss a petition if it determines that the debtor did not file the petition in good faith or that the petition does not meet the requirements of title 11. Id.

If the petition is not dismissed upon an objection, the Bankruptcy Code requires the court to order relief, allowing the case to proceed under chapter 9. 11 U.S.C. 921(d).

AUTOMATIC STAY

The automatic stay of section 362 of the Bankruptcy Code is applicable in chapter 9 cases. 11 U.S.C. 362(a), 901(a). The stay operates to stop all collection actions against the debtor and its property upon the filing of the petition. There is another provision of the Code, however, which expands the stay to entities other than the debtor. The additional automatic stay provisions under section 922(a) prohibit actions against officers and inhabitants of the debtor if the action seeks to enforce a claim against the debtor. Thus, the stay prohibits a creditor from bringing a mandamus action against an officer of a municipality on account of a prepetition debt. It also prohibits a creditor from bringing an action against an inhabitant of the debtor to enforce a lien on or arising out of taxes or assessments owed to the debtor. Section 922(d) of title 11 limits the applicability of the stay. Pursuant to that section, a chapter 9 petition does not operate to stay application of pledged special revenues to payment of indebtedness secured by such revenues. Thus, an indenture trustee or other paying agent may apply pledged funds to payments coming due or distribute the pledged funds to bondholders without violating the automatic stay.

PROOFS OF CLAIM

In a chapter 9 case, the court shall fix the time within which proofs of claim or interest may be filed. Fed. R. Bankr. P. 3003(c)(3). Many creditors may not be required to file a proof of claim in a chapter 9 case. For example, a proof of claim is deemed filed if it appears on the list of creditors filed by the debtor, unless the debt is listed as disputed, contingent, or unliquidated. 11 U.S.C. 925. Thus, a creditor must file a proof of claim, if the creditor's claim appears on the list of creditors as disputed, contingent, or unliquidated.

COURT'S LIMITED POWER

Two of chapter 9's provisions are designed to recognize the court's limited power over operations of the debtor: sections 903 and 904. Section 904 of the Code limits the power of the bankruptcy court to "interfere with - (1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property," unless the debtor consents or the plan so provides. The provision makes it clear that the debtor's day-to-day activities are not subject to court approval and that the debtor may borrow money without court authority. In addition, the court cannot appoint a trustee (except for limited purposes specified in section 926(a)) and cannot convert the case to a liquidation proceeding. The court also cannot interfere with the operations of the debtor or with the debtor's use of its property and revenues. This is due, at least in part, to the fact that in a chapter 9 case there is no property of the estate and thus no estate to administer. 11 U.S.C. 902(1). Moreover, the chapter 9 debtor may employ professionals without court approval, and the only court review of fees is in the context of plan confirmation, when the court determines the reasonableness of the fees. The restrictions imposed by section 904 are necessary in order to ensure the constitutionality of chapter 9 and to avoid the possibility that the court might substitute its control over the political or governmental affairs or property of the debtor for that of the state and the elected officials of the municipality.

Similarly, section 903 of the Code states that "chapter [9] does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of the municipality, including expenditures for such exercise," with two exceptions - a state law prescribing a method of composition of municipal debt does not bind any nonconsenting creditor, nor does any judgment entered under such state law bind a nonconsenting creditor.

ROLE OF THE UNITED STATES TRUSTEE/BANKRUPTCY ADMINISTRATOR

The role of the United States trustee in chapter 9 cases is typically more limited than in chapter 11 cases. Although the United States trustee appoints a creditors' committee, the United States trustee does not examine the debtor at a meeting of creditors (there is no meeting of creditors), does not have the authority to move for appointment of a trustee or examiner or for conversion of the case, and does not supervise the administration of the case. Nor does the United States trustee monitor the financial operations of the debtor or review the fees of professionals retained in the case. Bankruptcy Administrators serve a similar limited function in chapter 9 cases filed in the six judicial districts in the states of Alabama and North Carolina.

Role of Creditors

The creditors' role is more limited in chapter 9 than in other cases. There is no first meeting of creditors and creditors may not propose a plan of adjustment. If certain requirements are met, the debtor's plan of adjustment is binding on dissenting creditors. The chapter 9 debtor has more freedom to operate without court-imposed restrictions. In each chapter 9 case, however, there is a creditors' committee that has powers and duties that are very similar to those of a committee in a chapter 11 case. These powers and duties include selecting and authorizing the employment of one or more attorneys, accountants, or other agents to represent the committee, consulting with the debtor concerning administration of the case, investigating the acts, conduct, assets, liabilities, and financial condition of the debtor, participating in the formulation of a plan, and performing such other services as are in the interest of those represented. 11 U.S.C. 901(a), 1103.

INTERVENTION/RIGHT OF OTHERS TO BE HEARD

When cities or counties file for relief under chapter 9, there may be a great deal of interest in the case from entities wanting to appear and be heard. The Bankruptcy Rules provide that "[t]he Secretary of the Treasury of the United States may, or if requested by the court shall, intervene in a chapter 9 case." Fed. R. Bankr. P. 2018(c). In addition, "[r]epresentatives of the state in which the debtor is located may intervene in a chapter 9 case. Id. In addition, section 1109 of the Bankruptcy Code permits the Securities and Exchange Commission to appear and be heard on any issue and gives parties in interest the right to appear and be heard on any issue in a case. 11 U.S.C. 901(a). Among those that may be interested in being heard in a chapter 9 case are municipal employees, local residents, non-resident owners of real property, special tax payers, securities firms, and local banks.

POWERS OF THE DEBTOR

Due to statutory limitations placed upon the power of the court in a municipal debt adjustment proceeding, the court is far less involved in the conduct of a municipal bankruptcy case (and in the operation of the municipal entity) while the debtor's financial affairs are undergoing reorganization. The debtor has broad powers to use its property, raise taxes, and make expenditures as it sees fit. The debtor is also permitted to adjust burdensome non-debt contractual relationships under the power to reject executory contracts and unexpired leases, subject to court approval. Municipalities may also reject collective bargaining agreements and retiree benefit plans without going through the usual procedures required in chapter 11 cases. The municipality also has the authority to borrow money during a chapter 9 case as an administrative expense. 11 U.S.C. 364, 901(a). This ability is important to the survival of a municipality that has exhausted all other resources. A chapter 9 municipality has the same power to obtain credit as it does outside of bankruptcy. The court does not have supervisory authority over the amount of debt the municipality incurs in its operation. The municipality also has the same avoiding powers as other debtors, may employ professionals without court approval, and fees are reviewed only within the context of plan confirmation.

DISMISSAL

As noted above, if an objection is filed, the court may dismiss the petition after notice and a hearing if the debtor did not file the petition in good faith or if the petition does not meet the requirements of chapter 9. 11 U.S.C. 921(c). A chapter 9 case may also be dismissed, after notice and a hearing, for cause, including lack of prosecution, unreasonable delay by the debtor that is prejudicial to creditors, failure to propose a plan within the time fixed by the court, nonacceptance of a plan within the time fixed by the court, denial of plan confirmation and denial of additional time for filing another plan, material default by the debtor under a confirmed plan, or termination of a confirmed plan by reason of the occurrence of a condition specified in the plan. 11 U.S.C. 930.

TREATMENT OF BONDHOLDERS AND OTHER LENDERS

Different types of bonds receive different treatment in municipal bankruptcy cases. General obligation bonds are treated as general debt in the chapter 9 case. The municipality is not required to make payments of either principal or interest on account of such bonds during the case. The obligations created by general obligation bonds are subject to negotiation and possible restructuring under the plan of adjustment.

Special revenue bonds, by contrast, will continue to be secured and serviced during the pendency of the chapter 9 case through continuing application and payment of ongoing special revenues. 11 U.S.C. 928. Holders of special revenue bonds can expect to receive payment on such bonds during the chapter 9 case if special revenues are available. The application of pledged special revenues to indebtedness secured by such revenues is not stayed as long as the pledge is consistent with section 928 [922(d) erroneously refers to 927 rather than 928] of the Code, which insures that

a lien of special revenues is subordinate to the operating expenses of the project or system from which the revenues are derived. 11 U.S.C. 922(d).

Bondholders generally do not have to worry about the threat of preference liability with respect to any prepetition payments on account of bonds or notes, whether special revenue or general obligations. Any transfer of the municipal debtor's property to a noteholder or bondholder on account of a note or bond cannot be avoided as a preference, i.e., as an unauthorized payment to a creditor made while the debtor was insolvent. 11 U.S.C. 926(b).

PLAN FOR ADJUSTMENT OF DEBTS

The Bankruptcy Code provides that the debtor shall file a plan. 11 U.S.C. 941. The plan must be filed with the petition or at such later time as the court fixes. There is no provision in chapter 9 allowing creditors or other parties in interest to file a plan. This limitation is required by the Supreme Court's pronouncements in Ashton, 298 U.S. at 513, and Bekins, 304 U.S. at 27, which interpreted the Tenth Amendment as requiring that a municipality be left in control of its governmental affairs during a chapter 9 case. Neither creditors nor the court may control the affairs of a municipality indirectly through the mechanism of proposing a plan of adjustment of the municipality's debts that would in effect determine the municipality's future tax and spending decisions.

CONFIRMATION STANDARDS

The standards for plan confirmation in chapter 9 cases are a combination of the statutory requirements of 11 U.S.C. 943(b) and those portions of 11 U.S.C. 1129 (the chapter 11 confirmation standards) that are made applicable by 11 U.S.C. 901(a). Section 943(b) lists seven general conditions to confirmation of a plan. The court must confirm a plan if the following conditions are met:

1. the plan complies with the provisions of title 11 made applicable by sections 103(e) and 901;
2. the plan complies with the provisions of chapter 9;
3. all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;
4. the debtor is not prohibited by law from taking any action necessary to carry out the plan;
5. except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that on the effective date of the plan each holder of a claim of a kind specified in section 507(a)(1) will receive on account of such claim cash equal to the allowed amount of such claim;

6. any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and

7. the plan is in the best interests of creditors and is feasible.

11 U.S.C. 943(b).

Section 943(b)(1) requires as a condition to confirmation that the plan comply with the provisions of the Bankruptcy Code made applicable by sections 103(e) and 901(a) of the Code. The most important of these for purposes of confirming a plan are those provisions of section 1129 of the Code (1129(a)(2), (a)(3), (a)(6), (a)(8), (a)(10)) that are made applicable by section 901(a). Section 1129(a)(8) requires as a condition to confirmation that the plan has been accepted by each class of claims or interests that is impaired under the plan. Therefore, if the plan proposes treatment for a class of creditors such that the class is impaired (the creditor's legal, equitable, or contractual rights are altered), then that class's acceptance is required. If the class is not impaired, then acceptance by that class is not required as a condition to confirmation. Under section 1129(a)(10), the court may confirm the plan only if, should any class of claims be impaired under the plan, at least one impaired class has accepted the plan. Even if no impaired classes of creditors consent to the plan, plan confirmation is still possible under the "cram down" provisions of section 1129(b). Under "cram down," if all other requirements are met except the section 1129(a)(8) requirement that all classes either be unimpaired or have accepted the plan, then the plan is confirmable if it does not discriminate unfairly and is fair and equitable.

The requirement that the plan be in the "best interests of creditors" means something different in chapter 9 than under chapter 11. Under chapter 11, a plan is said to be in the "best interests of creditors" if creditors would receive as much under the plan as they would if the debtor were liquidated. 11 U.S.C. 1129(a)(7)(A)(ii). Obviously, a different interpretation is needed in chapter 9 cases because a municipality's assets cannot be liquidated to pay creditors. In the chapter 9 context, the "best interests of creditors" test has generally been interpreted to mean that the plan must be better than other alternatives available to the creditors. See 4 Collier on Bankruptcy 943.03[7] (15th ed. 1994). Generally speaking, the alternative to chapter 9 is dismissal of the case, permitting every creditor to fend for itself. An interpretation of the best interests of creditors test to require that the municipality devote all resources available to the repayment of creditors would appear to exceed the standard. The courts generally apply the test to require a reasonable effort by the municipal debtor that is a better alternative for its creditors than dismissal of the case. Id.

A special tax payer affected by the plan may object to confirmation of the plan. 11 U.S.C. 943(a). Other parties in interest may also object to confirmation, including creditors whose claims are affected by the plan, an organization of employees of the debtor, and other tax payers, as well as the Securities and Exchange Commission. 11 U.S.C. 1109(a), 1128(b), 901(a).

DISCHARGE

A municipal debtor receives a discharge in a chapter 9 case after (1) confirmation of the plan, (2) deposit by the debtor of any consideration to be distributed under the plan with the disbursing agent appointed by the court, and (3) a determination by the court that securities deposited with the disbursing agent will constitute valid legal obligations of the debtor and that any provision made to pay or secure payment of such obligations is valid. 11 U.S.C. 944(b). Thus, the discharge is conditioned not only upon confirmation, but also upon deposit of the consideration to be distributed under the plan and a court determination of the validity of securities to be issued.

There are two exceptions to the discharge in chapter 9 cases. The first is for any debt excepted from discharge by the plan or order confirming the plan. The second exception is for a debt owed to an entity that, before confirmation of the plan, had neither notice nor actual knowledge of the case. 11 U.S.C. 944(c).

At any time within 180 days after entry of the confirmation order, the court may, after notice and a hearing, revoke the order of confirmation if the order was procured by fraud. 11 U.S.C. 901(a) and 1144.

The court may retain jurisdiction over the case for such period of time as is necessary for the successful implementation of the plan. 11 U.S.C. 945(a).